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## CURRENCIES AND CREDIT MARKETS

No. 254 / June 1994


"A fair rule of thumb is that when economists agree that a currency will rise, it will fall. Look at the dollar."

The Economist
May 14th-20th, p.19

## HIGHLIGHTS

As events unfold and more statistics become available, if anything, we can only say that the Great Financial Bubble is bigger than even we thought. We must conclude, therefore, that its bust can only be worse than originally envisioned.

In the meantime, while the securities markets are labouring to maintain positive sentiment, another shock has hit — a weak dollar. Theoretically, it wasn't supposed to be possible. It's caught the world financial community by complete surprise and only heightens the confusion in financial markets even further.

Events so far this year betray the fact that there is precious little real liquidity underpinning the securities markets. Otherwise, the slight rises in the Fed funds rate wouldn't have triggered such violent reactions in the stock and bond markets. The unwinding of the bubble will not be easy.

As a rule, when the Fed raises rates, bond yields usually increase at a lesser rate, causing the yield curve to flatten or inverse. The fact that the exact opposite is happening, calls two elements up for question: the Fed's policies and market liquidity.

The view that low inflation rates as measured by the traditional price indexes is the infallible proof of an absence of any inflation, in our opinion, strikes at the very heart of current market deception. The truth is that actual inflation is very high. We explain.

Why did the bond market crash in Europe? Short and simple, for the same reason as in the U.S.: Despite the different and more attractive cyclical and monetary fundamentals, it was a bubble that burst.

Forget all the arguments about "low inflation" and "high real rates." It's time to realize that the global bond markets are in the grip of a gathering liquidity crisis. All the evidence we see suggest that it will get worse.

It is a common feature of all speculative bubbles that they start with wonderful wealth effects, only to end in massive wealth and liquidity destruction. That fact remains the touchstone of our investment view: The preservation of liquidity remains all-important. Investors should continue to limit themselves to short-term bonds in the hard currency markets and cash-type investments.

## THE SPECULATIVE EXCESSES REVEALED

It's now seven months since world bond markets began to topple and, so far, recovery attempts have only been grudging. It would only be normal, even in the worst of crashes, to at least expect a partial, temporary recovery. But, to date, every beginning bond market rally to the upside — North American, European, or otherwise — is instantly met with a wave of selling pressure that quickly snuffs it out. Clearly, some dynamic is under foot in the bond markets that needs to be identified and explained.

Most policymakers, investors, economists and financial pundits — right to the highest levels — simply don't understand what's going on. In their view, the bond declines just shouldn't have happened . . . that the rule of market fundamentals was temporarily suspended. Robert Rubin, the economic advisor to the Clinton administration, personified this sentiment perfectly. When asked by a worried President Clinton about the bond market declines he explained: "*Economic fundamentals don't provide the answer. The market was functioning differently than it had in the past.*" Amazingly, that's the explanation that's being widely accepted for the countless billions that have been lost.

In reality, there is no mystery at all about this carnage in the global bond markets. As we have so carefully described over the past half year and more, what happened is a classic case of a bubble bust, one of the largest, most speculative, ever. As events unfold and more statistics become available, if anything, we have come to the conclusion that the prognosis for a continuing unwinding of this great bubble is even worse than we had thought before.

## RECENT MARKET TRENDS: A RENASCENT OPTIMISM

Despite the general stupefaction, it's surprising that there's so little concern about any probable after-effects on the markets and economies. Underlying this smug attitude is a ready belief that the sudden rate surge around the world won't do any serious harm to the economic recoveries in the United states and Europe. These rate rises have been written off as just a hysterical reaction of inflation-phobic bond investors. And, it's this perception that's apparently giving the stock markets their surprising resilience to the bond crash.

Market pundits have settled into their new groove and are busily repeating new formulas for bullish financial markets. "*A world recovery is under way,*" "*a profit-led recovery*" almost everywhere, that "[U.S.] *economic growth will slow in the second half* [due to] *natural constraints on growth rather than* [. . .] *a monetary tightening,*" "low world inflation"" are just some of the new siren songs beckoning investors onto the shoals of shaky world financial markets. Gauging by recent market actions — just as we anticipated in earlier letters this year — these stories are finding ready believers. Most stock exchanges are broaching their highest recovery levels since the troubles began.

All these viewpoints imply that worldwide stock and bond prices have seen their worst and should therefore, in due time, correct themselves to the upside once inflation fears prove unwarranted. In short, we see more of the same old complacency than real concern over the outlook for the economies and the markets. Financial markets are not yet prepared for the worst, an outcome, we think, that deserves some thought and examination.

## A CURRENCY DERAILED

In the meantime, while the securities markets have been labouring to maintain positive sentiment,

another shock has been in the making — a weak dollar. It's caught the world financial community by complete surprise and has heightened the general overall confusion. According to the consensus script, it just wasn't possible. The perception of stronger U.S. economic growth, associated with rising interest rates against a global backdrop of progressive monetary easing in Europe and Japan, had created a universal dollar bullishness. There was hardly a broker or financial institution that had not gone long the dollar. Shorting the mark and the yen with visions of an inexorably rising dollar was seen as a surefire "money-in-the-bank" bet. The irony is that the script played out just as the consensus had predicted — U.S. interest rates rose, European rates declined — except for one thing: the dollar slumped. Why?

Though the securities markets were jubilant immediately following the Fed's recent rate hikes, the currency and commodity markets are betraying disagreement. With the dollar weak and commodity prices (CRB) having soared to three-year highs, the price action is more consistent with a U.S. central bank that is still too easy relative to the rest of the world. In this sense, the markets are correct. However, the commodity surge is a chimera. Why? Because the supposed strong world recovery won't likely happen.

## ODD TRENDS IN INTEREST RATES

In the U.S. case, a most unusual development has attracted our attention: market interest rates — from Treasury bills to 30-year bonds — have been reacting more strongly and in advance of the Fed funds rate which is pegged by the Fed. Every time the Federal Reserve raised its rate a bit, those rates determined by the markets have risen even more sharply.

While the Fed's first tiny rate hike clearly started the process, ever since, its funds rate has progressively fallen behind the markets, steepening the yield curve even further. This is in diametrical contrast to the ordinary pattern during periods of monetary tightening. Normally, in such environments, the yield curve flattens. As a rule, when the Fed firms rates, bond yields always move up only a fraction of the rise in short-term rates thereby causing the yield curve to flatten or inverse. The fact that this is not happening makes us wonder about Fed policy and market liquidity.

On the face of it, a growing gap between sharply rising market rates and lagging federal funds rate is suggestive of two things: firstly, that the Fed is really not tight at all but rather accommodative; and secondly, of a gathering liquidity crisis in the U.S. bond market as overleveraged institutions and investors try to unwind their positions.

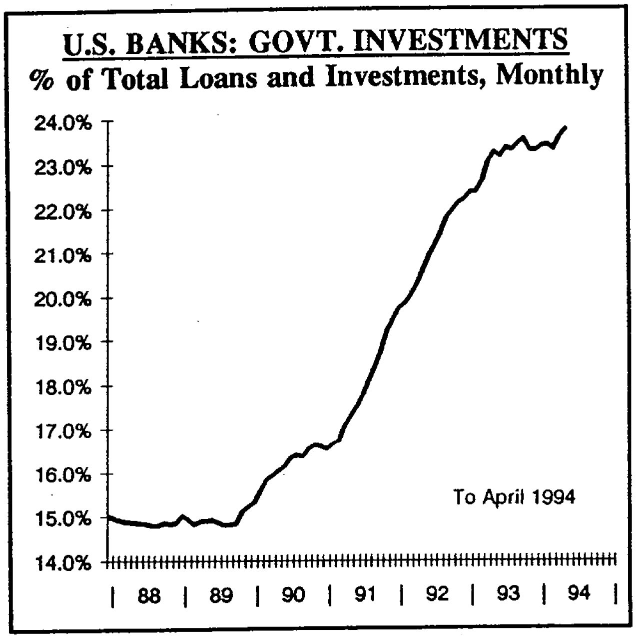
Bond mutual funds are suffering steady redemptions. But that's small potatoes when compared with the relentless selling pressure from the numerous institutions who are trying to reduce their leverage and cut losses. Just who is left to buy in a market where everybody is overinvested, if not overleveraged?

Taking the case of the commercial banks, for which complete and recent statistics are available, during the three boom years, 1991-93, these institutions poured $283 billion into bonds, piling up a bond portfolio totalling $940 billion. These enormous purchases by banks clearly played a crucial role in forcing up bond prices.

How have the banks reacted to the bond crash? The very first reaction was to buy, obviously thinking

that the slump was a splendid buying opportunity. Between the end of January and mid-April, banks pumped $45 billion of new money into the bond market. Ever since, however, they appear to have had second thoughts as they have been small net sellers of bonds.

In view of their huge portfolios, the bond collapse must have hit the banks with tremendous losses. Liquidity, though, is no problem for them given a continuous, ready supply of reserves by the Fed. In that sense, the Fed's posture remains easy indeed. However, in this market, the mere absence of new big bank buying is fatal.




## SPECULATION WITHOUT MONEY GROWTH

More precarious is the liquidity position of the big yield-curve players outside the banking system — financial institutions, corporations and wealthy individuals — who play this speculative game of buying bonds financed through short-term borrowing. With their highly leveraged portfolios, they are dependent on short-term money borrowed from banks, corporations, and institutions that are rather more jittery and limited in their provision of liquidity than the Fed. As soon as these creditors sniff large losses, they are likely to demand repayment of loans, thus triggering more bond sales and further losses.

Yield-curve playing when it is building momentum, whether done by banks or non-banks, is bullish for the bond market and indirectly for the stock market, too. From a monetary point of view, however, there is an important difference as to the identity of the player. When it is done by banks, it results in the creation of new deposits . . . . that is, an increasing money supply. However, when non-banks do it among themselves, it merely involves a transfer of existing bank deposits from the lender to the borrower thus leaving total outstanding deposits unchanged. In this case, overall debt rises but money supply does not.

We mention this because there's no way to reliably measure or trace the scope of the yield-curve playing that has taken place among the non-banks. Brokers, which are the only non-bank players captured by the Fed's statistics, carried a bond portfolio totalling $318 billion at the end of last year, up from $158 billion at the end of 1990.

During the 1980s, bond portfolios of these same brokers and security dealers used to total around $10-20 billion. Thus it goes without saying that their new, gigantic yield-curve playing also played a crucial role in fostering the financial boom of the 1990s. Their main sources of finance were repos, customer balances and bank credit, of which only the latter adds to the money supply.

As we have said, there are no central statistics available that reveal the scope of financial leveraging that

has taken place during this era of ultra-cheap money. However, in hindsight, it becomes clear that the speculation involved the greater part of the U.S. financial system and trillions of dollars. Taking banks, brokers and all the other non-bank players together, their government bond purchases may easily add up to $1 trillion and more during the last three years. That's a lot of bond buying. No wonder the bond market soared during that time.

## SEARCHING THE FOUNDATIONS

Bubble or no bubble? That, in fact, is the most important question. To the extent that it is, provides insight into whether the financial debacle is near its end or has only just begun. But in order to be able to assess the current condition of markets, we first need to know how they got there. Although the statistics are sparse, what we can find is truly scary.

As is well known, over the past four years, after first trying to prevent a recession and help bail out the banks, the Fed has been desperately auguring to stimulate a recovery. To do so, it lowered its funds rate from nearly 10% to 3% during this period. As the economy responded only sluggishly, the Fed kept cutting and cutting — altogether twenty-two times.

Since long-term rates increasingly lagged behind the declines in short-term rates, the prolonged aggressive monetary easing produced a steeper and steeper yield-curve . . . in fact, the steepest in history. Not surprisingly, that was an irresistible lure to large parts of the financial community to exploit the big spread between short- and long-term rates (by borrowing short and investing in longer-term fixed-income instruments) all the while making capital gains as the entire yield-curve fell.

The financial community grabbed this once-in-a-lifetime opportunity to make big money with abandon. While the Fed delivered the necessary loose money, economists delivered the inspiring pseudo-scientific slogan postulating that falling inflation surely justified lower long-term interest rates. Given this false confidence, no one was inclined to ponder where all the money that was fuelling the boom was coming from, even though the U.S. budget deficit was exceeding the total supply of savings and European budget deficits were exploding.

While the economy continued to flounder, trillions of dollars flooded into the financial markets from all sides and through many channels. Where, in fact, did all this money suddenly come from? Definitely not from personal savings which barely totalled $630 billion over this period.

In retrospect, it's easy to recognize that the Fed's prolonged, monetary looseness unleashed two large money streams. Given the poor state of the economy, these pushed their way into financial markets, fuelling the hectic price run-up on Wall Street. The one fuel was debt; the other was cash. The debt-driven yield-curve playing fuelled the bond market; the unprecedented "flight from cash," mainly on the part of individuals, primarily drove the stock market. There can be absolutely no doubt now that the global financial bubble of the 1990s was the direct result of the cheap money policy that the Fed perpetrated during this time.

## PAST LESSONS NOT LEARNED

What's wrong with this loose money policy and its many effects, considering that it has lately, after a

long lag, also fuelled a strong acceleration in the growth of the real economy? Well, what was wrong with the asset price inflations in Japan, Britain, Australia, Canada and other countries during the late 1980s?

Before they finally burst, everybody far and wide promoted them as healthful developments in view of the apparently benign backdrop of low inflation. Low inflation, by the way, as we've mentioned in past letters, has always been a part of previous asset bubbles. Why? Because it has always duped the monetary authorities of the day into policies of excessive ease and has delayed a necessary monetary tightening. During the halcyon days of Japan's stock market and real estate bubble, its economy had an inflation rate of 1%-2%. It is a common feature of all such bubbles, that they start with wonderful, roaring wealth effects, but all end in massive wealth and liquidity destruction, in turn triggering deep recession if not depression.

Yet, central bankers and economists seem to have learned nothing from the world's many previous lessons regarding the nature of bubbles, not even from the most recent experience, Japan's. Mostly, there is a flat refusal to accept the notion that an inflationary "asset bubble" might exist. Irrespective of the many dismal lessons of the past, it is still the standard view that a low inflation rate as measured by the traditional price indexes infallibly proves the absence of any inflation. It is this view, in our opinion, that strikes at the heart of current deceptions about financial markets. Why can't we learn from history? The following anecdote illustrates this point.

## WHAT IS INFLATION? AN OLD ISSUE

The very same question — the role of inflation — was a big issue of debate between John Maynard Keynes and some American economists before the stock market crash of October 1929. It all started in the boardroom of an insurance company of which Keynes was chairman. One member of the board, O.T. Falk, alarmed Keynes in the summer of 1928 with the warning that a serious inflation in America would eventually provoke a monetary tightening by the Fed. In consequence, he recommended to the board that the company should dispose the bulk of its U.S. securities.

While strongly objecting to this view, Keynes nevertheless took care to ask two leading American economists for advice — one in the Fed, the other at Harvard — and sent them a paper under the heading: *"Is there inflation in the United States?"* Referring to the persisting stability of the U.S. price indexes, he concluded the paper with a categoric "no", basically arguing that: " *The test of inflation is the test of consumer prices."* For him, the boom on Wall Street was driven by plentiful savings which had to be offset through the pumping up of credit by the Fed.

To his surprise, his American correspondents answered him by arguing that he was wrong to limit his definition of "inflation" to only commodity prices. Both pointed out to Keynes that the key relevant inflation factor was an excessive credit expansion, in this case one which had largely expressed itself through speculative channels.

Keynes owned no U.S. shares, but convinced of an ongoing boom, was heavily long in commodities. In 1928, market trends suddenly turned against him. Expecting an impending recovery, he stuck with his investments until the commodity collapse had wiped out nearly 85% of his financial wealth. Mr. Falk, the individual that originally had warned Keynes, reversed his view in the summer of 1929. He

became bullish. Sadly, his large losses later forced him to put his house up for sale.

Last but not least, it may be mentioned that the leading American apostle of the New Era in the 1920s, who had achieved such fame with his preaching that a permanent low inflation in the United States assured a permanent stock market boom, ruefully recanted in 1932 in his book "Booms and Depression." Professor Irving Fisher there admitted that stock prices should also be used as an indicator of inflation. He had paid dearly for this lesson — the total loss of his large fortune. Keynes also partly recanted his view later in the book "A Treatise on Money."

Returning to the present, the practical question for the moment is whether the steep decline in bond prices has fully unwound the massive leverage that has been built up during the past three years of prolonged, excessive monetary ease. In other words, has the enormous and hazardous overhang of leverage been removed or is there more forced selling to come?

## MARKET LIQUIDITY IN COLLAPSE

As there was in the late 1920s, there is a lot of babbling today about the excellent fundamentals that underpin the financial markets. "Inflation is low," "a world economic recovery is gaining momentum," "a productivity-led profit explosion" are among the main pitches used to argue the attractiveness of markets. But that's all rather besides the point. Rising stock and bond markets need liquid investors and institutions that can buy them. To that end, we don't see any remaining potential buyers.

The unpalatable fact is that the market carnage so far has done very little to shake out the speculative positions. True, most hedge funds are reported to have either exited or collapsed, forced out by margin calls. But, in general, bond holdings, leveraged or not, have been maintained, partly in the hope that a rally will offer better prices; partly because the cash markets themselves are proving to be pretty illiquid. In any case, markets moved so fast, it wouldn't have hardly been possible for bond holders to adjust their positions. So much for the famous "liquidity driven" financial markets.

Most of the action so far has been taking place in the derivatives markets. So what we see is that hedging is given preference over liquidation. A recent article in the Wall Street Journal, "Bond Volatility Adds to Frenzy of Future Pits", confirmed our worst assumptions about an unfolding liquidity crisis: *"Investors try to cut their losses by dumping holdings, thereby worsening the downward spiral. The selling frenzy was especially tumultuous in Treasury-bond futures because that was one of the few markets that had enough liquidity to absorb such a wave of sales."*

Meanwhile liquidity in the bond markets, both cash and futures, has completely broken down. The traders with whom we speak tell us of a virtual collapse in transactions. Every little rally immediately triggers another wave of sellers. Some observers say that there is no post-war precedent for such market indigestion. Certainly, in terms of the rate of the decline, the bond market slump has been one of the fastest in history.

What makes the collapse in market liquidity so alarming is that it is occurring against a backdrop of relative monetary ease. The few rate increases by the U.S. Federal Reserve to this point have been minor relative to the carnage of 1979-80 when Paul Volcker, then Chairman of the Fed, jacked the funds range up to 21%. At that time, it should be remembered, there were no mature derivatives and futures

markets to help improve liquidity and stability. Today, we see bond markets crashing with a Fed funds rate of 4.25%. That alone should be a clue that some serious illiquidity problems are lurking underneath.

In any case, illiquid cash markets are bound to cause illiquid futures and derivatives markets over time. For every investment manager who wants to limit his risk by hedging, there has to be a willing risk-taker on the other side. Considering the steep declines in bond prices, the main market makers in the corresponding derivatives — mostly banks, if not, somebody else somewhere — must have incurred terrific losses. We are not surprised to hear that bond futures markets, too, are also becoming unaccommodative. The fact is this: Only bull markets are liquid markets. The severity of the bond market declines reveal the true underlying condition — that there really isn't any real "money" liquidity underpinning markets. It's all been "bull market" or what might be called "transactional" liquidity, the type that vanishes the moment a bear market starts.

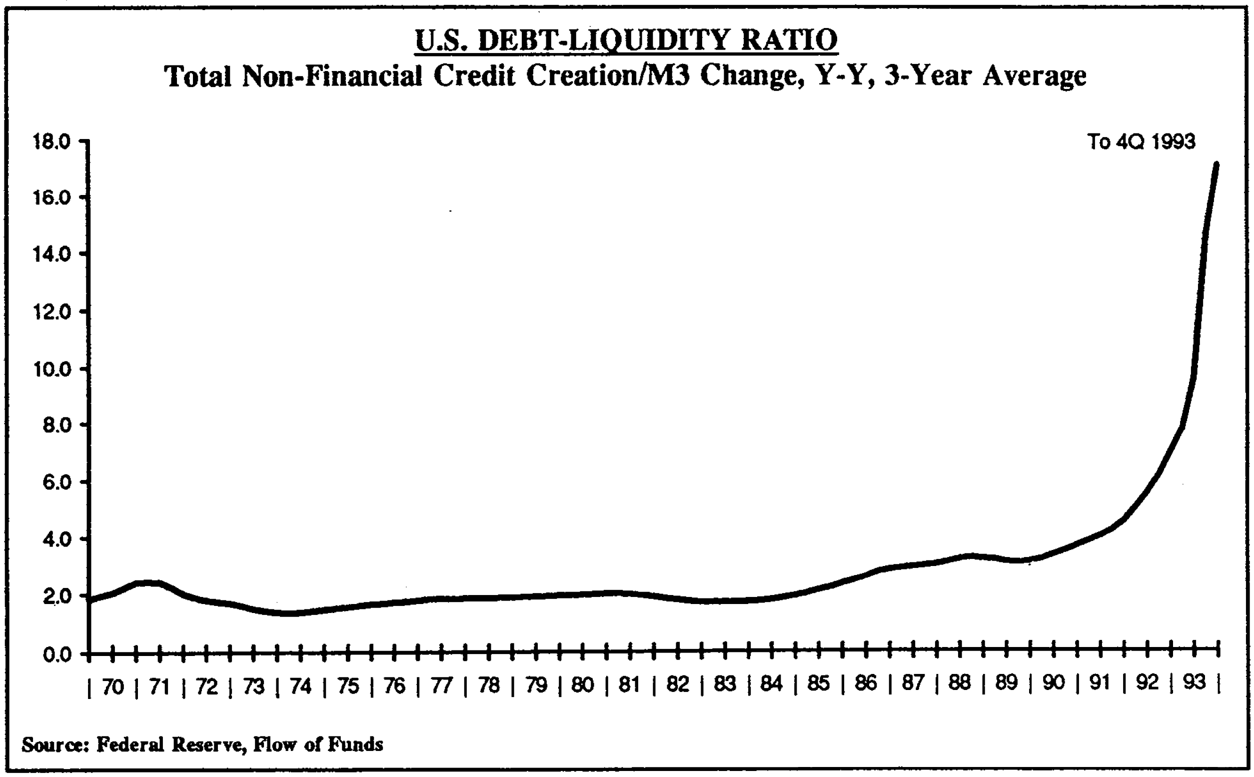
In short, it's time to realize that bond markets in general — the U.S. bond market particularly — are in the grips of a gathering liquidity crisis. All the evidence we see suggests that it will become worse. Forget all the arguments about "low inflation" and "high real rates." It's all gobbledy-gook and doesn't apply to a post-bubble market. It comes down to a simple question of buyers and sellers. When a bubble bursts, there are many more potential sellers than buyers and the whole unwinding process takes on a momentum of its own. Just as securities valuations can become ridiculously excessive on the upside, they can also become unbelievably cheap on the downside. But just where does a liquidity crisis stop? With this question in mind, we again take another critical look at developments in the U.S. financial system over the past few years.

## CREDIT CREATION WITHOUT MONEY CREATION

In the last letter, we pointed to a sharply growing discrepancy between credit and money creation in the United States. During the three years 1991-93, non-financial debt — that is the debt of corporations, consumers and the governments — grew a total of $1.66 trillion, while broad money (M3) — the aggregate liquid assets of these sectors — grew by a mere $156 billion. Debts therefore expanded ten times faster than liquidity. Seen in this light, (see also the graph on the opposite page for a perspective on the trend of this debt-liquidity ratio) the flight from liquidity over the past few years has had far greater dimensions than is realized.

This trend towards more credit with less and less money liquidity has its basic cause in the structural shift in the U.S. financial system from bank lending to securitization. More and more lending is being done through the securities markets via bonds and other types of paper. For example, rather than owning mortgages, banks sell off their mortgages to organizations that package them up and resell them as securities to investors as CMO's (Certified Mortgage Obligations) or other similar type instruments. This long-term trend received an explosive boost courtesy of the Greenspan-Fed's steeply inclined yield curve. Securitized mortgage lending soared at the expense of mortgage lending by banks and S&L's. Essentially, this shift in financing reduced the money supply.

Since 1990, the Wall Street bull market, together with the wave of refinancing, has stimulated the creation of nearly $1.2 trillion of new mortgage securities of which over $500 billion represented new lending. Today, it's a market that's completely illiquid. Securitization, like everything else, is wonderful in a bull market. But it backfires terribly in a bear market.




## THE SEARCH FOR LIQUIDITY

Several reports we have read recently suggest that markets ought to recover now that the flight to cash is over. There couldn't be a greater illusion. It's an ironclad fact that investors cannot collectively raise their liquidity by buying and selling securities among themselves. For every seller who takes his money out of the market, there must be a buyer who puts the same amount back in. Therefore, overall liquidity remains the same over the short-term.

The massive flight from cash into securities over the past few years has boosted market prices, creating big paper wealth and paper liquidity. Conversely, any major attempt to shift out of equities and bonds (or mutual funds) back into money will instantly gum up the markets with illiquidity, and trigger a collapse in prices. It's inevitable that this will happen . . . at some point.

The usual complacent answer to such concerns is that the Fed will take care of any liquidity problems. Well, it was the Fed who created this liquidity mess to begin with. In doing so, it has hardly shown any great foresight. In any case, the Fed can do very little. In theory, there is only one way that financial markets and the overinvested, overleveraged investors and institutions can be reliqefied: The Fed must again slash short-term rates again and flood the banks with reserves, so that they will buy an enormous amount of bonds, in that way boosting the prices of fixed-income securities (dropping long-term rates) and raising the money supply (aggregate liquidity).

Can it be done? Is it feasible? Definitely not. A central bank that resorts to desperate measures can

only cause panic in the markets. As well, the banks with their already overgrown bond portfolios would not comply. Such measures, in any case, could trigger a collapse in the dollar which in turn would further drag down stocks and bonds. Only the gold bulls would celebrate. But even though the outcome of such a course of action would prove disastrous, the Fed may have no other choice but to try.

## BOND MARKET EXCESSES: A GLOBAL ACTIVITY

What was surprising about the U.S. bond crash was how quickly it reverberated around the globe, decimating bond markets everywhere irrespective of sharply differing economic, monetary and market conditions. For most of last year, international bond speculators — mostly Americans — had been flocking to European bond markets on the bet that European central banks would further lower interest rates in the aid of their recessionary economies. The central banks have since complied, and in fact, have accelerated these moves after the U.S. rates hikes and the dollar decline took place. It's because these moves have neither stabilized the dollar nor the bond markets, that one hears the general lament that markets aren't behaving logically. Although the bond markets have not made any new lows in recent weeks, the volatility remains chilling.

What then was the logic behind last year's boom in European bonds to start with? Was it the result of fundamentals or just another speculative mania? As we have done in the past on this question, we answer with another question: How do you determine a speculative bubble? Again, it comes back to simple demand and supply. How much of the bond purchases were funded from genuine savings and how much as a cause of loose money and pure short-term speculation?

It's a calculation that can be made from the available statistics of many countries. So the emergence of a bubble should be readily identifiable and of no surprise to anyone. But nobody seems to want to pursue this question in any case. Limiting our scope for the sake of simplicity, we just focus on Germany and the United States as the key countries for this question. The figures in the table below reveal a lot about the extent of international Bund speculation and also explain the confounding rise of the German money supply.

**PURCHASES OF GERMAN BONDS**
**DM Billions**

| | Banks | Domestic Investors | Non-Resident Investors |
|---|---|---|---|
| 1989 | 71.8 | 128.1 | 20.5 |
| 1990 | 31.3 | 127.4 | 60.7 |
| 1992 | 113.5 | 35.4 | 135.2 |
| 1993 | 142.1 | 11.2 | 229.1 |

**Source: Bundesbank**

Reviewing the numbers for 1989 and 1990, the period just after unification when long-term interest rates were near 9%, the biggest buyers were primarily domestic individuals and institutions. As interest rates fell, domestic buyers went on a "buying strike." Instead, it was the sophisticated international players — banks, hedge funds, and portfolio management professionals — that piled in and continued their buying right down to the historically-low interest rates levels of late last year.

Statistically, Germany therefore was experiencing a huge capital inflow. But the reality was actually

quite different. Most of these inflows were offset by a soaring outflow of short-term money, mainly from banks. What happened was that the German banks provided Euro-banks with large amounts of D-marks which, in turn were lent to the international hedge funds and others who were madly speculating in the Bund markets. Actually, German net capital imports last year were a mere DM 38 billion, equivalent to the current-account deficit.

While German policymakers hailed these huge foreign bond purchases as a sign of international confidence in their policies, these buyers were really speculating on a soft Bundesbank policy much like the U.S. Federal Reserve, anticipating a boost to financial markets driven by drastic rate cuts.

What finally dashed this expectation was a recent remark by the Bundesbank president, Tietmeyer, who said, "*. . . no more rate cuts.*" The comment promptly triggered a heavy selling wave in European stock and bond markets by U.S. fund managers. Very probably, Tietmeyer's comment was intended to calm the German public who were growing uncomfortable with the Bundesbank recent easing moves, especially the most recent one which seemed to be in deference to the U.S. need for dollar support. In the process, he may have overlooked the sensitivities of the international bond speculators who primarily are interested in quick capital gains.

So much for the famous anti-inflation vigilantes as far as world bond markets are concerned. The international bond players aren't on some altruistic mission to police central banks nor to regulate inflation trends. It's quick profits they're after and nothing else. High or low inflation is only of speculative interest to the bond players. If it were any different, Tietmeyer's comments would have been received more positively.

Nonetheless, it should be the responsibility of the central banks to make sure that the crazy conditions that breed speculative bubbles aren't allowed to come about. Why did the bond market crash in Europe? Short and simple, for the same reason as in the U.S. — a bursting bubble.

## GERMAN LIQUIDITY PREFERENCE

On top of it all, the rampant bond speculation is grossly distorting the German money supply to the upside. Principally, Germany's soaring broad money growth has two causes. Firstly, German savers have an extremely high preference for liquidity and therefore put most of their savings into bank deposits. However, this by itself wouldn't raise deposits. It is banks, who in turn are simultaneously making huge bond purchases, that cause this to happen. Thus, the banks are creating the deposits that the public saves.

It was the hope of the Bundesbank that by lowering short-term rates, German investors would be drawn into making bond purchases, thus alleviating the pressure on money growth. But the problem is that investors think that long-term yields aren't very attractive currently. They can't be blamed for taking that stance. It's not often that German bond yields have been near 6% in the past three decades.

Germany's money growth development is in striking contrast to that of the U.S.: The German investor is hoarding liquidity as never before because of a mistrust of the government fiscal policy and its large deficits; U.S. investors, on the other hand, have become illiquid as never before as they ran from low-yielding money deposits.

## CONCLUSIONS

What is fundamentally bearish for stocks and bonds around the world is simply the fact that the inflated flows into these markets during the past three years were simply unsustainable. At present, only two issues remain open to question: First, "Just how vulnerable will the financial markets be to the unwinding of the great speculative bubble? and second, "What will be the potential risks for the economies?"

We think that the markets and the economies are much more vulnerable than is generally realized. One shouldn't forget that once a bubble has been created, its collapse is inevitable. And if the carnage in the bond markets so far is indicative — by some measures already the worst in history — the economies cannot escape untouched.

The main source of the optimism that still prevails is the perception that the U.S. economy is leading a world recovery. This view essentially assumes that the financial crash is over and that sustained market stability, if not a renewed rise, is assured. If anything, given the new data we see, the great speculative bubble is even bigger than we had originally thought. We think the financial markets are virtually immobilized with a degree of illiquidity that may be unprecedented in the annals of modern-day financial history.

In our view, new setbacks in the financial markets are likely to choke off economic recovery prospects. Given the high-riding expectations, disappointment is warranted in any case.

The worst that can happen to global financial markets and the world economy is a prolonged fall of the U.S. dollar. Its continuing weakness despite a drastic narrowing of U.S./European interest rate differentials and the good news about the U.S. economy is alarming and ominous.

We continue to maintain a strong preference for the hard currencies. In Europe, the countries of Germany, Switzerland, Austria and Netherlands all qualify in this regard. However, liquidity remains all important. Investors should only focus on cash securities and shorter-term bonds.

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